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Rational Pension Supervision

First Experiences of Central and Eastern European States in Comparison with Other Countries

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Introduction:
Goals and Subject Matter of the Report

New financial institutions, pension funds, are being established in Central and Eastern Europe, that are also an important element of the social security system. They provide an additional source of income in old age. This source is all the more important insofar as public, pay-as-you-go pension systems in many countries are having problems with meeting previous pension commitments, which were often excessively generous and did not take into account potential changes in demographic conditions and the labour market.

Pension funds are primarily business entities whose financial success brings benefits to their participants – future old-age pensioners. At the same time, though, these are social institutions, as they contribute to securing income in a socially difficult situation – for old age. Their goals thus include both high effectiveness, leading to the increase of invested premiums so that these provide income whose growth rate would not be lower than the rate of wage growth, coupled with a high level of operational safety to make sure that future benefits can be paid at a level ensuring, at least, that the real value of invested premiums is maintained.

Pension funds work simultaneously towards the two goals – economic and social – and these goals are interlinked. Success in achieving the economic goal increases pensioners' future incomes, and the security of attaining an appropriate level is achieved automatically. On the other hand, relentless striving for a high rate of return carries a risk factor. The highest indices are achieved on the most risky investments. However, regulation of the funds' operations in the name of their safety limits the chances for attaining higher returns – not only because investment freedom is limited, but also because safety instruments are costly and reduce the amount of resources possible to invest. Reconciliation of the two goals of pension funds, the economic and the social, is therefore a difficult problem requiring great competence.

Societies in Central and Eastern Europe are very sensitive to the issue of the operational safety of new financial institutions, and especially pension funds. One can still observe mistrust of capitalist institutions, while initial experience with private entities such as banks, savings societies and insurance companies has not always been positive. In this situation, ensuring safety by introducing a whole arsenal of security and guarantee regulations together with the regulations on establishing funds becomes a political goal that conditions the very passing of laws on private pension funds.

The subject of our consideration will be the experiences relating to pension fund regulations from the point of view of their safety of operations in five countries of Central and Eastern Europe. These countries represent two groups. **The first includes Hungary and Poland**, where the decision to establish pension funds was made earlier on. Thus, they can now share their own, though modest, experience, especially Hungary. Moreover, the debate in both countries was very extensive and heated [Ferge, 1998; Golinowska/Hausner, 1998]. **The second group includes Bulgaria, Estonia and Lithuania**, the countries that passed laws on pension funds in 1999. In this period, it was the issue of introducing regulations on the safety of operations and on guaranteeing a specified level of benefits from pension funds that was extremely relevant.

In analysing the socially safe functioning of pension funds, special attention has been devoted to institutions supervising the pension funds.

The present work was developed in the following order. The first step involved the identification of risks and their ranking according to the degree of danger (cf. Part 1). In the second chapter we discuss the instruments for safeguarding against and reducing the appearance of risk. For these instruments, it was important to define them, as well as to analyse the legal regulations, administrative standards, financial management standards, codes of ethics, the formula and competence of supervisory institutions, and the working of the market. Before presenting the principles and means of balanced supervision over pension funds, in Part 3 we have pointed out the basic dilemmas of achieving a balance between economic and social goals. Next, we have attempted to show the proper balance between regulatory instruments and self-regulation in order to achieve a fund's balanced operations in terms of both effectiveness and safety (cf. Part 4).

The fifth part of the report shows the practical experience of other countries, including those with much more experience in this area than can be found in Central and Eastern Europe. Taking into account the history of pension funds' development in these countries, we observe two roads of development of safety institutions.

One way is to establish these institutions *ex post*. First, funds were established, without any special supervisory regulations, and operated for many years without any disturbances, or with only minor ones, until a large-scale scandal emerged. As a consequence, regulations were created to prevent excessive risks. In the United States in the 1970s, there was the ERISA package of regulations, and in the United Kingdom a dozen or so years later, after the scandal with Robert Maxwell's pension funds, the Good's Commission was established which went on to prepare a proposal for supervision.

The second way involves establishing supervision *ex ante*, at the same time as the regulations on pension funds. This solution is characteristic of the Latin American countries, which undertook pension reforms in the 1980s and 1990s, introducing a capital pillar. The countries of Central and Eastern Europe are also undertaking safeguard regulations *ex ante*.

The *ex ante* road is more difficult insofar as one has to be able to identify any potential threats to the funds' safe operation and have a good knowledge of the various instruments (preventing dangers) and their functioning in a balanced way from the point of view of reconciling effectiveness with social goals.

The last chapter presents the modest experiences of five Central and Eastern European states. The report ends with conclusions and recommendations, while the extracts of law on supervision over pension funds are cited in the appendix.

The project was conducted in co-operation with three research teams from partner institutions:

1. Audrone Morkuniene, Elena Leontieva, Aneta Lomovska (the project co-ordinator), from the Lithuanian Free Market Institute (LMFI), Lithuania.

2. Maria Prohaska, Ivaylo Nikolov, from the Center for the Study of Democracy, Bulgaria.

3. Ramil Pärdi, the Jaan Tonisson Institute, Estonia.

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Part 1
Analysis of Risks Related to Pension Funds' Operations

The risks related to the functioning of pension funds will be analysed from the point of view of a participant in the new system – the future recipient of benefits [1]. We assume that a risk is the probability of the emergence of a situation in which the value of assets (collected premiums and profits from investing them) on an individual pension account is lower than the optimal level possible to attain. The appearance of a risk results in the loss of real – due to the drop in real value – and potential income of the benefit recipient, and its appearance depends on various factors. The broader the definition of risks, the more factors there are involved. To identify risks, it is useful to divide them into **internal risks**, which can be counteracted by a given fund, and **external risks**, which the fund may be threatened by, regardless of its actions [2].

The term "pension fund" used subsequently in the paper denotes both an organisation managing the assets gathered in the fund (in Polish terminology called a pension society) and the fund itself, meaning the gathered assets, unless issues are discussed that require the two to be precisely differentiated.

1.1. External Risks

Analysing external risks against which a fund is unable to work out the proper safeguards, the following risk factors can be mentioned:

– weaknesses of reform implementation,
– political pressure on the investment decisions of pension funds,
– weakness of legal regulations, including the lack of supervisory bodies or their badly defined role,
– weakness of the pension system's partners,
– underdeveloped capital markets,
– risk of interest rate changes,
– risk of foreign exchange rate changes, and
– risk of inflation.

Weaknesses in the implementation of pension reform carry the **danger of deviations from the programmed pension system model** that has been approved. This risk may be caused by pressure from certain groups of interest. If the public authorities are unable to resist that pressure, the initial rules are abandoned and new ones introduced. One example of applying pressure to change the approved solutions in Poland involves demands to abandon the investment limits in force, and demands to introduce tax-related benefits for organising the "third pillar" and participating in it. When joining a fund is voluntary, tax-related benefits can have a strong impact on increasing the motivation to participate.

Another source of deviations from the approved pension model can involve **changed political set-up as a result of elections**. This risk consists in generating new legal regulations as a result of implementing different ideological concepts, as well as the policymakers' striving for short-term goals, e.g. resulting from a heavy budget deficit. Though political risk is much greater in public pay-as-you-go systems [3], it can also occur in the privately managed section (of the pension system). In such cases, it is very important to agree on the draft with the political opposition before it becomes the subject of a parliamentary debate.

Deviation from the approved model of changes and political pressure on the funds' investment decisions are dangerous external risks. On the one hand, they may seriously shake social trust in the proposed reforms, while on the other, such changes obviously arouse the distrust of private organisations interested in taking part in pension fund

[1] It is possible to analyse the risk in other distinctions than, as proposed here, in dychotomic approach: the pension fund as the financial institution versus its members. For example, Turner (1996) proposes the analysis of risk bearing between pension fund, its sponsors, workers, employer and government.

[2] Other approaches are also widely used. The risk in pension plans can be considered in three market areas: labour market, financial market, and political market. Cf. Turner (1996).

[3] It is worth noting the great effort required for all the political forces and social partners to achieve a compromise when passing the law on pension funds in Poland [cf. Golinowska, Hausner, 1998].

management. Changes made during implementation may also increase the cost of the new system.

The next important external factor is **the lack of cohesive legal regulations for pension funds**, in particular the improperly defined role of supervisory bodies.

First of all, the new institution of the pension system may be badly placed in the existing system of supervisory organisations. If the supervisory organisation is separate i.e. only for pension funds, an unclear division of competence between it and existing organisations for supervising other players on the financial market is possible. Situations of under-regulation may appear, for instance if the new supervisory body's range of competence does not include investment processes, while the Securities Commission – established for such a purpose – considers itself relieved of the duty of supervising pension funds in this respect. Another example of vagueness in this area that is currently apparent in Poland is supervision of employee pension programmes. Wherever the form of the pension system's third pillar is not an employee fund, then apart from the Office for Pension Fund Supervision (UNFE), there are two institutions that can be authorised to supervise pension programmes. These are the State Office for Insurance Supervision, because these are life-insurance based programmes; and the Securities and Exchanges Commission, because these are investment-type programmes assigned to trust funds.

Secondly, dangerous situations can occur as a result of **the excessive "openness" of supervision regulation**, namely in assigning an important role to supervisory bodies' discretionary decisions, and/or accepting vague (insufficiently specified) rules of action towards the funds. In the countries undergoing transformation it is especially important to define precisely the rules for division of responsibilities and to develop clear procedures. It seems that in a situation of lack of experience and lack of systematic standards of behaviour, under-regulation can be more dangerous than excessive regulation. Moreover, in cases of under-regulation, there is too much room for political pressuring and political decision-making.

Another area of potential danger for pension funds could be the **weakness of partners operating in the whole pension system**. The issue here is the lack of coordinated actions among institutions regulating and administrating the whole pension system, in both the public and private sectors. The weaknesses in the pension system's public part may result mainly from insufficient adaptation behaviour in situations when unexpected trends appear [4]. Lack of preparedness for the possibility of difficult and unexpected situations leads to tension and undermines social trust in the new system. In Poland, this risk appeared following technical problems on the part of the Social Insurance Company (ZUS) (the public pension institution) with transferring premiums to private pension funds [cf. Skrobisz, 1999].

In the area of private fund management companies, the weakness may involve a tendency towards institutional oligopoly, which leads to a **lack of healthy competitive behaviour** under conditions of high barriers to entering the retirement benefit market. This risk can appear especially at a later period, after the pension fund market structure forms and strengthens, when the fight for customers weakens. The lack of competitive behaviour can also occur due to over-regulation of the funds' operations, e.g. through the requirement for a minimum rate of return. Being long-term savings organisations, pension funds can occasionally record lower profitability than the required minimum for the whole system. In a situation where the deficit is to be financed from the assets of the management company, pension funds – fearing infringement of their assets – often give up their own long-term investment policy in favour of copying the leaders.

One factor that effectively restricts pension fund management is **under-development of the capital market**. This factor is especially important in the emerging markets, which are undertaking to build new market institutions as part of the transformation process. The experience of other countries, such as Chile, shows that pension funds can contribute to the development of those markets, but on the condition that the market is prepared for absorbing a significant demand for financial instruments [5].

Good functioning is conditioned by the proper scale of **absorptiveness of the domestic capital market**. Experts estimate that in Poland, given the present state and dynamics of development, the capital market will be able to absorb the funds' demand for securities in stock-exchange trade for the next two to three years. It is very likely, however, that later on, in a situation where the number of available financial instruments is limited, pension funds will be unable to invest effectively due to both the market's limited size and the fixed portfolio structure (limits on investing in a given instrument).

The capital market's development could be hampered not only by the insufficient rate of privatisation but also due to the lack of regulation of some areas of the market. One example of such a drawback in Poland is the market for public trading of debt securities, and corporate and municipal ones in particular [Kozłowski, 1999].

[4] In Hungary, excessive criticism of the old solutions caused the population to move towards private funds to a much greater degree than expected. This trend also appeared in Poland despite the greater level of safeguarding against it. In Kazakstan, participation in capital funds was made obligatory for all insured persons, regardless of the fact that such a decision is simply unprofitable for people with a longer period of being insured.

[5] Vittas (1999) argues that if pension funds operate in a conductive regulatory framework, they have a beneficial interference on financial market development.

Areas that require proper market standardisation and regulation for pension funds to be able to invest in them include public infrastructure and real estate. Until there appears the possibility of daily valuation of securities from those markets (debt securities, debenture bonds, etc.), pension funds will be unable to invest in them. In the case of the real estate market, as yet unresolved ownership issues are an additional difficulty delaying its regulation.

The under-development of the capital market is also linked to lack of stability. No one needs convincing as to the existence of this risk. Sudden changes in the prices of assets undermine investment strategies.

The next external risk is the **possibility of a downward business cycle**. Market analyses using different methods and assumptions aim to minimise the risk of wrong decisions, including those related to movement of share prices on the stock exchange. However, this risk cannot be eliminated completely.

The same is true for the **risk of foreign exchange rate changes** (investments in foreign securities) and for the **risk of interest rate changes** (investments in debt securities). These risks are external elements that are an inseparable feature of the investment process. One of the possible strategies for limiting these risks is to purchase certain derivative instruments. However, this kind of safeguard is only just forming on "young" capital markets. Decision-making in the emerging markets thus carries a higher risk than on developed capital markets.

Inflation is an important risk that carries substantial weight in Central and Eastern European post-communist countries. When inflation is high (a two-digit figure), a rational and safe investment policy is seriously threatened. In Poland, the single-digit scope of inflation (since 1998) enabled private companies to enter the "pension industry". It should be noted that in the first half of the 1990s, in spite of serious discussions of experts on pension reform, private financial institutions could not be counted on to get involved. This was mainly due to the high inflation risk, which at that time was the greatest barrier for private organisations' participation in the new system.

1.2. Internal Risks

There are three main areas of pension funds' operations where internal risks may occur, and these shall be analysed here.

They are:

1) administrative (fund management),
2) social (rights of fund members), and
3) business operations.

1.2.1. Administrative Risks

Administrative risk concerns the organisation managing the fund (the pension society). The risk may involve the inability for conscientious and effective management of the entrusted funds.

Inadequate administration of a pension fund's resources can be due to several factors. It may occur due to the **management personnel's low qualifications**. With insufficient competence, especially in financial management, it is hard to make accurate and sensible decisions.

The condition involving high qualifications is also related to the issue of **division of competence in the society's management board**. The division of tasks and responsibility should be clear and specific. This is made possible by, among other things, internal decision-making procedures (by-laws) leading to individual responsibility.

Another threat to the funds' effective operations can be a **functional imbalance between actions for the benefit of shareholders and those for the benefit of fund participants**. The pension society board has its clients – fund members – on the one hand, but it also represents the interests of the shareholders – founders of the society. The latter may pressure the board to invest the fund's resources in projects related to their own business operations. This kind of pressure may lead to engaging resources in projects that do not bring profits to the fund's participants, while being a cheap source of capital for the society's founders. If a pension society's board succumbs to pressuring, this will be the beginning of unjustified transfers of assets between the pension fund and the administrating company, or between different programmes for different groups of participants.

Other potential risks threatening the interests of insured persons might involve management take-over processes and pension society consolidation, and finally the announcement of a society's bankruptcy.

Moreover, the administration process may lack standards concerning financial matters, such standards that are usually followed by institutions wanting to be perceived as professional businesses. This risk could involve improperly prepared financial reports and inadequate bookkeeping. When such standards exist, the problem may lie in the fund board's capacity to comply with them. Inadequacies in this respect may lead to erroneous decisions, while on the other hand, the fund's financial situation can be purposely distorted in the report system.

1.2.2. Social Risks

Social risks include endangering the rights of insured persons in terms of participating in a fund or the worsening of conditions of obtaining benefits. Social risks are not uniform.

Violation of the interests of insured persons can have a variety of aspects.

Firstly, the information reaching clients considering joining a pension fund may be distorted. When wanting to decide whether to participate, potential members of capital funds are entitled to complete and reliable knowledge of their rights and possible alternatives. Clear and honest information should be provided both by the mass media and by the **person dealing with direct sales of retirement services** (the pension fund's salesperson). Information provided by the media should not be misleading and should not refer to other alternatives (funds) in the form of a negative campaign. The key element, however, is a face-to-face meeting between the client and the fund's salesperson. Due to the large degree of complexity of a pension fund's functioning, prospective clients often have to rely on the salesperson's knowledge and advice. A salesperson, on the other hand, may persuade clients to join the fund without having their genuine interests at heart. This occurs, for instance, when a commission-based motivation system that focuses only on signing up new members is used with salespeople. If, in addition, a salesperson is attached only briefly to the pension fund, there exists the possibility of falsifying data on fund membership.

A risk that can directly strike fund participants is the **lack of standards safeguarding the participants' interests when entering into an agreement with the pension fund**. The source of this lies in the asymmetry of information between the fund's agent and the prospective client concerning possible solutions. The risk appears when the agreements on pension fund membership are vague or ambiguous. A person joining a fund may wrongly understand the agreement's unclear content, while comparing alternatives when making a choice is difficult if there are no standards on the contents of agreements.

In the event of a disadvantageous financial situation, a fund may strive to change the terms of the agreement in order to reduce participants' future claims. Thus, social risk may appear **in the way changes are made to the pension agreement** that could be detrimental to the fund's members.

Unequal treatment of fund participants may also emerge in the form of **unequal division of income from the fund's investments**. Invested resources generate an income whose distribution may turn out to be disproportionate in relation to each member's contribution. Then, a given group of insured persons would gain more from the income generated by investment than others.

Equally important are limitations related to switching fund membership. We know from experience that unlimited client freedom leads to high administration costs due to a high rate of insured persons' fluctuation. Restrictions for participants should be minimised, however, and should be as uniform as possible for all the funds.

In a fund that not only increases the resources obtained from premiums but also pays out benefits once members reach retirement age, there is the possibility of the risk of **paying out lower benefits in a given fund compared to others**. The social risk lies in the fact that a fund participant comparing the benefits received by other persons with similar social status and a similar pre-retirement career may consider their own pension to be too low. Of course the sources of this type of danger are found in other areas, mainly in the level of fund management costs or investment policy effectiveness. One should remember, though, that if such remissness is excessive, this could lead to a strong social reaction expressed in a sense of losing out in relation to other benefit recipients from the private system.

1.2.3. Risks Related to the Fund's Business Operations

In analysing the **economic aspects of risk**, we will focus on the following two areas:

1) the investment process,

2) the fund's day-to-day operations.

Investment risk stems from the nature of a pension fund's operations, consisting in increasing the collected resources in the long term [6]. Obviously, in view of changing market conditions, investment operations of any organisation on the capital market carry a risk.

The primary risk in the investment process is **a fund's low profitability**, which means the fund has not worked out the optimal profitability rate that it is possible to attain under a given set of conditions. It should be noted that we are talking about optimal profitability, namely that which is possible in the current market situation.

Another approach involves relative profitability – compared to other funds. Leaving aside the criterion of evaluation here, this risk means that a fund generates lower income than is possible to achieve.

Errors in managing a pension fund's resources may result from, for example, the **lack of professional market analyses**. Here again we touch on the issue of suitably high qualifications, which are essential in fund management. A bad or incomplete analysis of the market and the appropriate instruments may lead to another threat, namely an inappropriate investment strategy. **Diversification of the investment portfolio** for a given rate of return may be

[6] According to Turner (1996), the capital market risks are grouped in the following groups: financial market risk, risk due to malfeasance, inflation risk, interest rate risk, risk due to the financial performance of the plan sponsor.

both **too "risky"** (when the risk is underestimated) or too conservative (when the estimated risk is greater than the real risk). The issue here is on what scale the pension funds will invest in company shares, and what part will be invested in debt instruments.

It is worth noting that the reference point in risk diversification comprises not only the level of investment risk but also the **period of investment**. A fund's investment policy should take into consideration the interests of the fund's members, which may be mutually exclusive. For a young employee whose prospects for membership in the fund span several decades, a policy of greater investment in shares will be more appropriate. As we know, in developed capital markets the rate of return on such investments in the long term is greater than it is on bonds. For an older person, with a dozen or so years membership, such portfolio diversification could be too risky, and may cause a given person to sustain losses due to the possibility of short-term fluctuations.

The risk of investing in preferred projects or investments recommended by the shareholders of the company managing the fund has already been discussed, but it is worth mentioning here as well, as it is one of the fundamental dangers that could potentially lead to low investment effectiveness. One could say that it includes all the analysed dimensions: economic, social and administrative.

The last area of risk in investment operations involves **bad management from the point of view of liquidity**. In the investment phase of a fund, the main element of uncertainty is the scale of predicted payments into the fund and the period of undisturbed inflow of premiums. Maintaining the proper level of liquidity is more important in the phase of paying out benefits, which is delineated by the members' retirement age. Analyses from the point of view of the liquidity criterion are also important for the fund's investment policy (purchasing various financial instruments). This is because such structures of engagement of resources are possible that limit the flexible introduction of favourable changes, which in turn reduces the effectiveness of the investment policy. The purchase of "bad" packages (similar to "bad debts" in the banking system) can also be detrimental to liquidity. In the emerging markets, the possibility of selling inconvenient securities is probably more limited.

As we have mentioned, investment operations are not the only area where economic risks can occur. A separate area comprises those factors of day-to-day operations that have a negative impact on the fund's financial condition.

Firstly, this can be a **vague division of assets between the society (management company) and the pension fund**. If the fund's finances are not clearly separated from the management company's, shareholders in the pension society or shareholders in its founding organisations may file claims on the resources of the pension fund, which is impermissible. Such shortcomings may result in the **risk of resources of fund participants being taken over** (by somebody else).

The high costs of fund management, in effect leading to decreased retirement benefits, can be a dangerous trend. From the point of view of a pension fund participant, fund management costs are determined by two factors. The first is the **level of fees and commission received for managing the fund**. It seems that in the countries undergoing transformation, where there is still a deficit of qualifications in investment advisory services, these costs may lead to a somewhat high level of administrative fees, despite extensive competition on the retirement services market in its early period.

The second element that could carry the risk of high management costs involves **external costs**, or transfers made from the pension fund to other financial institutions for specialist services, e.g. to a bank where the fund's resources are deposited or to the company maintaining a register of fund members. Firstly, services ordered by the pension society may be performed improperly or incompletely, which increases costs and has a negative impact on the fund's profitability. Secondly, the transfer of resources could be disproportionate in relation to the cost of the services.

The final risk in day-to-day operations comprises **weaknesses in the proper valuation of assets**. The value of assets, and especially the value of a participation unit in a pension fund, is one of the important elements taken into account when choosing a pension fund.

1.3. Ranking of Identified Risks

Though the presented description of risks points to the main danger areas in the functioning of the funds, it does not show which of these areas are the most important in the countries under consideration. That is why experts from the countries taking part in the study specified such risk groups using a point method of risk grading.

Each risk area was to be allocated a degree of danger. For this purpose, a five-degree scale of risk was chosen, expressed in assigned points, in decreasing order. This means that "1" marks those areas in the functioning of a pension fund that carry the greatest risk. Consequently, "5" was assigned to those risks that are of minimum importance. Moreover, it was decided that in those areas where the degree of risk is 4 or 5, there is no need to develop special remedial measures. On the other hand, in areas where the degree of risk is higher (1 – 3) a more in-depth analysis will be necessary, leading to the development of specific safeguards (instruments).

In the countries covered by the analysis – Bulgaria, Estonia, Lithuania and Poland – the risk most dangerous to the funds' functioning was perceived to be the lack of cohesive legal regulations, and erroneously defined functions of the supervisory body (1 point). The risk of lack of competitive behaviour on the part of pension funds was also considered important, especially in the context of a lack of reliable information on a fund's financial situation (2 points). Areas where the degree of danger was considered moderate (3 points) included under-development of the capital market, a downward business cycle, and weakness of the financial institutions providing services to pension funds. The other groups of external risks, including political risk or instability of the domestic currency (inflation), were seen to be unimportant.

In considering the dangers from internal risks, the evaluations are harsher than those described above. This is especially true for economic operations and members' rights (social risks). In economic operations, the areas considered the most burdened with risk (1 point) are as many as five:

– inappropriate diversification of the portfolio from the point of view of risk,

– inappropriate diversification of the portfolio from the point of view of the insured persons' interests,

– investing in investments suggested by the pension society's (management company's) shareholders,

– improper valuation of the fund's assets, and

– ambiguous rules for separating the assets of the society from the assets of the pension fund.

The risk of inaccurate analyses and financial planning as well as the danger of losing financial liquidity (the risk of investing in difficult-to-sell instruments) was also seen as highly probably (2 points). A moderate value was given to two kinds of economic risk: high management costs and foreign exchange rate risk (3 points). In the case of Poland, this last area was the only one given four points among economic operations. There was no risk in the economic operations category that received the lowest mark of five points.

In the social area, or that concerning the rights of persons participating in a pension fund, the most dangerous areas were: (1) the lack of standards protecting the clients' interests at the moment of signing the agreement and (2) the way changes are made to that agreement, which could lead to losses for the client. The other groups of dangers (restrictions on switching to another fund and the unequal distribution of income from investment operations) were also considered important (2 points). The only exception is the risk of discriminating against certain social groups in terms of access to participation in a fund, which was seen as being moderate. This seems apt, mainly because this kind of risk is not very probable in countries where the capital pillar of pensions is introduced as an obligatory element.

In the area of pension fund management, the experts thought that the greatest risk was the excessive involvement of the pension society management in operations other than the functions for the benefit of pension fund members. Thus, the main danger is pressure on the pension society management from its shareholders. The other administrative areas, except the risk of ambiguous division of tasks and responsibilities, were also assessed as being dangerous. There were no weak marks (4 or 5 points) in the group of administrative risks.

One should note that the overall assessment, which sums up the experts' evaluations in the analysed countries, was significantly different in some areas than the view taken by experts from Poland. This was especially true for assessment of the danger from external risks, where the differences in evaluation were the greatest. Contrary to the overall assessment, most of the external conditions were considered important in the case of Poland (1 to 2 points). Apart from bad legal regulations, the factors considered the most disadvantageous included the public pension system's inefficiency and high inflation (1 point). Also considered "dangerous" are the badly defined role of supervision, the lack of healthy competition between the funds in winning clients, under-development of the capital market, and its instability (2 points). In evaluating the situation in Poland, there was no external factor that was perceived as being moderate, while the other groups were seen as unimportant. For internal risks, the differences were small, not exceeding one point, and consequently will not be described in detail.

It seems that the distance in evaluations of external risks between Poland and the other countries is the effect of longer experience due to the earlier introduction of pension reform. Just under a year from the enactment of the main regulations allowing private pension funds to be established (from 1 January 1999), a number of shortcomings were observed in Poland, which will be discussed later (cf. part 7.1. of this report). Among the greatest dangers for the funds' functioning in Poland is the lack of flexible action in the public system. This is an important conclusion from Polish experience for those countries where the funds are just beginning to operate and where unpredicted, external weaknesses of reform have not revealed themselves yet.

The above analysis of risks of pension funds shows how many factors, both external and within the funds themselves, can threaten the interests of future benefit recipients. In addition, taking into account the necessity to gain public trust in the new pension system institutions, including pension funds, it is necessary to create a set of solutions that will protect the funds from the emergence of these risks. These instruments are particularly important when capital funds appear as an obligatory part of the reformed pension system.

Part 2
Instruments Safeguarding Against the Appearance of Risks in the Operations of Pension Funds

The analysis of potential risks in pension fund operations, presented in the first chapter, has shown the most important danger areas for effective operation. These risks have been presented as potential risks, as they do not have to emerge if the proper instruments are included in the new pension system. These instruments' basic function is to minimise the risks of participating in private pension funds. The issue here is not only about legal safeguards aimed at establishing state supervision over private pension funds, but also the development of self-regulation mechanisms.

This part of the report will present the possible, basic kinds of instruments safeguarding against the emergence of risks in the functioning of pension funds. These instruments play a varied role in individual phases of introducing the new pension system. Some are of key importance at the design stage of the new pension system model, up to the moment when the necessary legal regulations are passed, while others are important when the new system is started up. Others still gain importance with the passage of time as new solutions consolidate.

Taking into account the as yet modest experience of pension reform in Central and Eastern European countries, one can identify the following kinds of **instruments** that correspond to the identified risks in pension funds' operations:

– The first kind of instrument involves **education on securing income for old age**. The target of such education is both the population as a whole and different groups of participants in the pension system. Such education in the countries undergoing transformation plays an important role in the understanding and acceptance of the system changes. The aim is to deal with false ideas about the way old-age pensions are financed, show the need for individual saving and describe future dangers that giving up the reforms could lead to. Moreover, thanks to a public debate on the new institutions – pension funds and the companies (pension societies) managing them – people are growing accustomed to new solutions. It is furthermore possible to gain full social confidence in the new institutions, as well as social control by introducing solutions correctly.

Equally important is more thorough education of participants in the pension system: employers as payers of premiums, employees – represented by trade unions for example, benefit recipients represented by pensioner organisations, prospective shareholders in the pension societies managing the pension funds, and administrators of the public pension system. One important element is to show both the good and bad experiences of other countries. These experiences should be comprehensively demonstrated, with the participation of experts who, thanks to their personal status and attitude, are reliable.

It is also important to supply **solid knowledge on the pension systems and reforms to the participants of the legislative process**. Considering both the election cycle (the fact that legislative authorities have a specified term in office) and the inertia of previous solutions, especially in the social area, the reform's authors need to convince [legislators] of the need to introduce changes, as well as ensuring these changes are passed. With this aim in mind, it seems essential to educate both ministry officials, who initiate new acts of law, and deputies and senators (especially those working on the acts in the appropriate committees), so that they respect the logic of the presented draft in their legislative work and do not succumb to pressure from groups of interest or to populist demands from certain employee groups.

The education of the media community, journalists and columnists who are responsible for the way the new concepts are presented (to the public) is impossible to overestimate. This presentation needs to be reliable and comprehensible. Moreover, it should promote the future benefits of introducing the reforms – not only the benefits related to individual pension levels, but also those related to the stability and solvency of the system as a whole. Good economic education of the public is the preliminary condition for the reform's success. This instrument is most important in the first phase, when the new pension system is being designed, and during the process of its passage.

– The public's education is linked to **promotion of the new system solutions**. Promotional activity differs from social education in that the former is conducted at the second stage of reform, when the structure of the new pension system is already decided. The target of the promotional activity is broad public opinion, to which the reform programme is addressed. In most cases this means the working population. Promotional campaigns can be carried out by various entities, both public authorities responsible for reform implementation (in Poland, the Government Representative for Social Security Reform) and the Office of Supervision, as well as the new emergent institutions (private pension funds). Thanks to promotion based on solid information it is possible not only to familiarise people with the new pension system but also to prepare the funds' prospective clients for making the decision to participate.

– Another important group of tools safeguarding against risk includes **the developed legal regulations** that form the basis for pension funds' operations. Legal regulations make it possible to prevent risks, especially internal ones. For example, **a legal structure of the funds** that clearly separates the fund as the collected assets of its participants from the pension society as the management company allows for greater protection of the gathered resources of fund participants. Also important are **the legal requirements for prospective fund founders**, which usually set tight conditions for entering the market. The law also specifies the conditions for the management of the funds' finances – day-to-day operations, investment activities and so on.

It is important the passed acts of law form a cohesive whole. This means that the regulations should provide a good platform for introducing the pension funds into the existing legal and economic system. It is worth adding that developing cohesive laws is a dynamic process and will be especially intensive in the reform's initial period. It will not lose importance later, though, because regulations require continuous adaptation to new situations.

– Once acts of law have been passed, there comes the important process of **forming new pension system institutions**. In Central European countries, the supervisory body is usually established first, and then the pension funds.

When establishing the supervisory body, the important issue is whether it will be a specialised body supervising only the retirement services market, or linked to supervision over the whole financial services sector. It is also important whether or not the supervisory body is politically and financially independent, namely to which institution it is responsible to for its actions, and what the sources are of its budget revenue. A certain role is also played by the procedure of the supervisory body in obtaining its regulations from its superior organisation, and the election method (the appointment of the supervisory body's chairman).

When establishing pension funds, one essential process is that of obtaining a licence for the pension society managing the pension fund and registering the funds in the appropriate registers.

– The nature of **the control and supervision over the whole pension fund system by a specialised institution** is determined mainly by the legal regulations, which give that body the appropriate competence. However, the practice and effectiveness of supervision is also influenced by other factors, including the pension funds' capacity for representing their interests.

Polish experiences show that besides the operation of pension funds, the other important area for supervision is the **system's public segment**. Supervision over the public system is especially important when it is responsible for collecting the whole of the premium and transferring the appropriate share to the funds.

– **Developing professional and ethical operational standards**. Besides complying with existing laws, the pension funds develop their own standards of conduct, which may be accepted and obeyed by all the market players. In civilised market economies, various procedures or rules of conduct (for accounting or customer service) are obvious and are obeyed – these are standards developed from years of experience. The funds will usually comply with them because they want to be perceived as professional institutions. In the countries undergoing transformation, however, many standards of conduct do not function yet, likewise even in the area of pension funds.

– **Self-regulation in areas of healthily competitive behaviour**. It can be expected that in specified situations, competition among the funds in order to gain clients will act as an instrument safeguarding against risks. This is especially true of the period of promoting new solutions, when most people to whom the reform programme is addressed will be deciding about joining a pension fund.

However, taking into account that the market for private pensions is a market with tight entrance restrictions, there may appear trends towards oligopolistic behaviour, neglecting the interest of fund members. This can occur particularly in the latter period. Restrictions on switching to a different pension fund can lead to this.

Part 3
Dilemmas Related to Sound Pension Fund Operation and Types of Supervision

The instruments, or tools, presented in the previous chapter form general guidelines. They are far from a ready-to-use arrangement for a specific country. The appropriateness and effectiveness of specific solutions largely depends on factors that characterise a given country's situation: its level of economic development, the population's affluence, traditions of business culture and co-operation, etc. The safe and effective operation of pension funds in a given country requires a proper set of tools that do not necessarily have to be universal, but whose deviation from the general rules should not be so numerous as to change the basic mechanism of the instruments' functioning. And if these deviations do occur, they should be rationally justified.

When constructing these instruments, the legislator faces many dilemmas. These may result from the contradiction between the goals of the system's new institutions and the tasks of the instruments used to safeguard against risks. We have identified the following dilemmas that need to be resolved in order to ensure a sound basis for the funds' functioning:

– The first dilemma involves **the conflict between social goals and effectiveness goals**. For private pension funds, the main criterion of operation is effectiveness aimed at achieving the optimal rate of growth of invested resources under given conditions. This does involve a risk, however. For the state, on the other hand, the funds' safety and stability is important, due to the desired social acceptance of the reform. Administrative or legal limitations – most often used towards investment policies – mean that the scale of operations is limited, which reduces in turn the funds' profitability. This price is much higher when the capital pillar is obligatory, because then, as mentioned above, supervision by the state is stricter.

– The second issue concerns **the character of pension fund supervision**. Taking into account the experiences of other countries, two models can be identified. Supervision over the funds can be **reactive**, when it acts in emergency situations and assumes greater independence of operation for the funds. One can say that it emphasises a more spontaneous development of the pension sector. **Active supervision**, on the other hand, anticipates any serious deviations on the part of the funds and undertakes day-by-day monitoring of practically all the fund's actions. In this option, the scope of regulation is broader, and we observe strong prerogatives for the supervising body.

The countries undergoing transformation may be encouraged to use the active model due to the lack of standards for administrative procedures and financial management, as well as the lack of ethical standards of conduct (e.g. a code of ethics for customer service). The reactive option, on the other hand, can be supported by the argument of ethical, i.e. careful, treatment of the developing, early retirement market, which could be "suffocated" by inflexible legal regulations hampering its development.

– One of the key elements for effective operation of pension funds is **the nature of relations between private pension funds and the supervisory body**. In practice, let us mention two possible variations of co-operation. The first involves close co-operation in taking up disputable issues and reaching a joint position. The second scenario assumes a conflict of interests and methods of operation. The pension societies, through their representatives, develop an alternative position and make use of lobbying (in parliament, for instance) to force through their own solutions. It seems that the former scenario ensures to a greater degree that operations will be safe and more effective.

– Also important is how the relations develop between funds themselves, especially in competing for participants. This is expressed in the **way they carry out advertising campaigns**. It seems there are two optional modes of action. The first involves honest and rational competition, with reliable information on the terms of participation in a fund, the financial results and management costs. The second possible option involves 'unethical' competition, introducing aggressive means of persuasion, without offering full information, and showing other funds in a negative light. As we mentioned above, a fund's promotion should be carried out in a rational way.

– Another problem for funds' efficient operation is **the nature of the financial policy implemented**. Should it be bolder and more risky, which means engaging the portfolio more seriously in publicly traded shares, for instance, or should it be a conservative policy investing most of the resources in state debt securities?

– The previous issue is also linked to **the range of possible investments in foreign securities**. This is not just a technical problem. In stable Western markets the investment risk is much lower than on the undeveloped markets in the countries undergoing transformation. Thus it is in the interest of the new system's participants to have the majority of a fund's resources engaged in securities issued abroad. However, pension funds are a stimulator of the domestic capital market's development and of the level of investments in the economy. That is why the public authorities will work towards limiting investments abroad in the interest of the economy and to stimulate the development of the domestic capital market. Which is more important: **the interests of insured persons, or the interest of the economy as a whole**? This dilemma is pointed out by Nikolas Barr in his analysis of the reforms undertaken in the countries of Central and Eastern Europe [Barr, 1999].

Part 4
Balanced Supervision of Pension Funds

Previously, we considered the areas where risks appear in pension funds and what instruments can be used to counteract those risks. In this chapter we shall attempt to answer the question: What instruments can be used to counteract

Table 4.1. External risks and instruments in the functioning of pension funds

Risks	Instruments
Weaknesses in reform implementation	Social education of experts, politicians and mass media
Political pressure on the funds' investment decisions	Systemic and legal solutions separating politics from business
Weakness of legal regulations in force, the lack of supervisory bodies or their badly defined role	Educating policy-makers Information about solutions used in other countries Taking into account the possibility of the supervisory body undertaking legislative initiatives Amending regulations aimed at effective supervision
Weakness of institutions administrating the pension system, including the public sector (ZUS)	Legal regulations Integral supervision over the pension system
Weakness of institutions in the financial sector (the depository bank, other institutions)	Legal regulations Business ethics Supervision of the financial sector
Under-development of capital markets	Consistent privatisation Developing new financial instruments
Risk of interest rate changes	Developing new financial instruments
Risk of foreign exchange changes	Consistent anti-inflation policy and good macroeconomic policies
High inflation	

Table 4.2. Risks and instruments in the administrative area of pension funds

Risks	Instruments
Low management personnel qualifications leading to bad management	Requirement for the proper managerial qualifications in the licensing process Supervisory action
Unclear division of competence	Requirement for internal division of responsibilities Professional standards of conduct for the funds
Functional imbalance between actions benefiting pension society shareholders and fund participants	Regulations safeguarding against conflicts of function Requirement of the clear separation of the assets of the fund and the society (management company) Supervisory actions of a state institution
Improper accounting and/or weaknesses in enforcing existing standards	A framework chart of accounts specified by law Professional standards of conduct for the funds Independent audit

effectively the risks to pension funds' functioning, while taking care not to stifle the funds' proactive and effective behaviour with excessive regulations and supervision?

Each group of risks has been analysed separately and the appropriate tools for combating them have been listed.

Let us start by analysing the external risks. It seems that in most cases, elements of social education and the development of good and cohesive legal regulations will be good instruments (cf. Table 4.1). Educating experts and politicians can prevent political risk, and help in developing efficient solutions and a well-placed role for state supervision over the funds. The key element will involve skilfully using the experience of other countries and developing one's own model of changes.

The risk of administrators' weaknesses damaging the pension fund system can be avoided thanks to good regulations, including those that guarantee efficient supervision over the public sector institution and the organisation that

Table 4.3. Risks and instruments in the social functioning of pension funds

Risks	Instruments
Inadequate or untrue information about the terms of participating in a fund	Educating salespersons Requirement of qualifications confirmed by an exam The possibility of clients' filing complaints against a fund Professional standards of conduct Code of ethics
Lack of standards safeguarding the interests of participants when signing an agreement with a pension fund	Educating the shareholders Professional standards of conduct Code of ethics
Methods of changing the terms of the agreement undefined or defined to the participant's detriment	Requirement of access to information on the financial consequences to the participant of the proposed changes The possibility of filing a complaint to the supervisory body against the fund's functioning
Limitations on switching funds	Regulations ensuring the possibility of leaving a fund The possibility of filing a complaint against the fund's functioning to the supervisory body
Discriminating against or in favour of specified groups of participants	Requirement of criteria of participation defined by law The possibility of filing a complaint against the fund's functioning to the supervisory body

Table 4.4. Risks and instruments in the economic activity of pension funds

Risks	Instruments
In the investment process	
Low effectiveness	Self-regulation through competitive behaviour Requirement of covering the deficit from the management company's resources
Improper policy of investment portfolio diversification	Legal requirement to invest in specified financial instruments Guaranteed minimum rate of return
Investing in the management company's own projects or in recommended investments	A ban or significant restrictions on such solutions Supervisory actions
Lack of financial liquidity	Developed standards of safe conduct
In day-to-day operations	
Flow of resources breaking into the fund's assets for the benefit of shareholders	Requirement of clear separation of the fund's and management company's assets Supervisory actions
High costs of fund management	Self-regulation through competitive behaviour
Improper valuation of assets	Legal regulations on valuation Supervisory actions Professional standards of conduct

transfers premiums to the private pillar (in Poland – the Social Insurance Institution, ZUS). In the countries of our region, given the under-development of the capital market consistent and decisive privatisation of further state property is essential.

It seems, however, that in view of most administrative risks, good regulations and an effective supervisory body are the essential condition (cf. Table 4.2). The risks of the management board's low qualifications and the lack of clear decision-making rules can be eradicated by defining the conditions that need to be met, especially at the moment when the fund starts operating. The risk of an imbalance in the management's actions for the benefit of fund participants and management company founders requires constant and active supervision.

There is also room for the funds to develop standards [themselves] (e.g. on the issue of the management company board's high qualifications). The problem of improper accounting can be secured by way of obligatory legislative solutions, but also based on developed standards. The requirement for an independent audit is conducive to compliance with the principles of reliability.

In the area of social risks, for which Table 4.3 lists the appropriate instruments, we find mixed solutions. Because these risks directly concern a fund member, the possibility of filing a complaint with the supervisory body is a new instrument not presented earlier. Actions taken on the initiative of the supervisory body alone do not seem sufficient.

When considering a client's access to reliable information, the decisive instrument will be not so much effective supervision, but rather a code of ethics and standards of conduct. If such standards are lacking, it is possible to use the legal requirement of a state exam to be passed by agents offering fund membership, which should partly eliminate persons ill-equipped for the job.

The instruments for economic risks are presented below in Table 4.4. In this, the last area of the analysis, the list of risks and instruments is different again. The proper instrument counteracting a relatively low profitability in relation to other funds involves, on the one hand, competitive stimuli on the market and, on the other, legal solutions guaranteeing the interests if insured persons (covering a deficit in resources from the pension society's [management company's] assets). The reaction to improper diversification of investment risk can be legal requirements (investment limits) and effective supervision over the funds' investment operations. For the risk involving liquidity of assets, it is sufficient to take advantage of the standards of conduct of financial institutions that are experienced in operating on the domestic capital market.

In day-to-day operations, the risk of unjustified transfers from the fund to the pension society has to be protected by good legal solutions and effective supervision. It seems that in the operating costs, self-regulation through competitive behaviour is an effective tool, especially since cost levels can be an important element when new participants choose a pension fund. On the other hand, control of cost levels by law or through administrative measures would seriously limit the autonomy of making any kind of decision.

Part 5
The Practice of Supervision Applied in Other Countries

Introduction

Pension funds, or institutions whose function it is to collect and invest resources securing incomes for old age, were established earlier than public pension systems. Many well-known companies created pension systems for their work force in the early 19th century at the time of the industrial revolution. By securing their employees' old age, employers were implementing a development mission. With time, when public systems developed widely in the late 19th and early 20th centuries, occupational pension schemes became of secondary importance. They became part of what we call the second pillar. The importance of occupational pension schemes decreased even more in the late 20th century. They became part of the third pillar of securing income for old age. The second pillar is made up of general capital solutions.

Pension funds today can be found in both the second and third pillars. These are usually institutions under private management that invest collected pension premiums. The premiums are voluntary or obligatory for participants, paid individually or collectively, transferred to the fund directly or via some other institution (financial or administrative). The legal status of pension funds varies. Thus, there are mutual insurance organisations, closed life-insurance organisations, non-profit organisations, and increasingly frequently today – joint stock companies. At the end of the 20th century there has been a tendency to standardise the legal formula of pension funds. The model for this standardisation is based on the solutions that emerged in the 1980s and 1990s in Latin America. Supervision over pension funds is also taking on a universal character, even though in specific solutions, there are still differences that grew out of local traditions.

5.1. Experiences of Latin American Countries

This section, devoted to the region of Latin America, consists of two basic points. The first provides an overview of both the development of pension reforms and the provisions applied in their supervision. The second point discusses the institutional aspects of pension supervision in Latin American countries.

5.1.1. The Development of Pension Funds in Latin America

Interest in pension funds in Latin America results from the fact that they are an important aspect of the widespread securing of income for old age, and in some countries have replaced the public system. This is therefore not a supplement to expansive, pay-as-you-go public financed systems, but a segment of the same if not greater importance than the public segment.

Why is it that, particularly in the countries of Latin America, the public and pay-as-you-go pension system is being replaced increasingly widely with a capital-based, privately managed system? Simplifying the issue a little, one can point to two important reasons. The first was linked to the poor condition of public systems, unbalanced and "damaged" by political decisions. As Jose Piñera, the author of the reform in Chile, said, "We built the new system on the ruins of the old one" (1996). The second reason was linked to the modernising mission of a new generation of politicians in Latin America, as pension funds became a source of capital for the development of domestic investments.

Pension reforms in Latin America went in three directions. Today we can say there are three new model solutions [Mesa-Lago and Kleinjans, 1997]. The criterion differentiating these models involves the proportions and relations between the public system (pillar one) and the newly established pension funds (pillar two).

The first model is a substitutive model. It involves completely or largely replacing the old system with the new one. This was the road taken by Chile (1981), Bolivia (1997), El Salvador (1997) and Mexico (1997).

The second is a mixed model, consisting of introducing the new segment while diminishing the old one. However, both segments still exist. This road was taken by Argentina (1994) and Uruguay (1996).

The third model is a parallel model. This means that pension funds appeared independently of the public system reform. They develop as an alternative, and as competition for the public system. This was the road taken by Peru (1993) and Colombia (1994).

Despite the varied methods of reforming the pension system in Latin America, their common element is the high degree of universalism in the construction of pension funds as institutions. As these are privately managed organisations and at the same time ones replacing a large part of the public systems, they are subject to relatively strong supervision.

The funds' investment policies are mostly determined by the applicable limits specified by law. On the other hand, the low degree of development of the capital markets is a strong limitation.

That is why funds in the great majority of countries in the region invest mainly in securities issued by the state sector. Mexico is a typical example, where investments in company shares are not permitted yet, and close to 95% of assets are invested in the state sector (cf. Table 5.2). Peruvian funds are an exception, as they invest most of their assets in the company sector. Another significant area of investment is that of securities issued by financial institutions (e.g. bank certificates of deposit), accounting for 25% to over 30% of assets.

Table 5.1. Latin America: Pension funds in reformed pension systems of selected countries (June 1999)

Country	Starting Date	Number of pension funds	Number of affiliates (thousands)	Average number of members in the fund (thousands)	Fund assets (USD thousands)
Argentina	May 1994	14	7,475.2	533.9	13,861.2
Bolivia	May 1997	2	448.9	224.5	380.7
Chile	May 1981	8	5,996.0	749.5	33,245.9
Colombia	April 1994	8	3,181.8	397.7	2,476.0
Costa Rica	August 1995	8	113.3	14.2	120.3
Mexico	February 1997	14	14,622.2	1,044.4	8,821.9
Peru	June 1993	5	2,106.5	421.3	2,082.5
El Salvador	April 1998	5	670.1	134.0	118.2
Uruguay	September 1995	6	15.0	2.5	476.9

Source: FIAP (1999)

The choice of reform strategy had a significant impact on the development possibilities of pension funds. The data in Table 5.1 show that Argentina and Mexico have the largest number of currently operating funds (14). The largest number of fund participants is also in those countries. However, one has to consider the fact that these countries have relatively large populations. The calculations in the table show how varied the average number of participants per fund is. The volume of assets gathered by the funds is greatly influenced by the degree of a system's maturity. One case in point is Chile, where the reform was carried out more than a decade earlier. The assets of funds operating in Chile account for more than half the resources amassed in all the countries under analysis.

Detailed analyses of investment limits show that in practice, the upper limits set by law are frequently not reached by pension funds. This is the case, for instance, in Argentina, Chile and Peru, as illustrated in Table 5.3.

As can be seen from the figures, restrictions do not necessarily require the aggregated amount to coincide with the legal upper limit. Also, individual funds usually establish

Table 5.2. Portfolio composition in selected countries of Latin America (June 1999)

Country	Total	State sector	Corporate sector	Financial sector	Foreign sector	Liquid Assets	Other
Argentina	100.0	52.8	19.6	25.4	0.3	1.9	-
Bolivia	100.0	66.6	-	29.4	-	4.0	-
Chile	100.0	37.3	18.6	31.6	12.4	0.1	-
Mexico	100.0	94.7	2.7	-	-	-	2.6
Peru	100.0	6.5	93.3	-	-	-	0.2
El Salvador	100.0	68.7	-	31.3	-	-	-
Uruguay	100.0	63.9	6.4	25.0	-	4.7	-

Source: FIAP (1999)

Table 5.3. Argentina, Chile and Peru: Comparison of investment limits and actual share of assets (June 1997)

Assets	Argentina		Chile		Peru	
(% of fund)	actual	maximum	actual	maximum	actual	maximum
Public-sector bonds	49.3	50	37.7	35/50	11.5	40
Private-sector bonds	4.8	28	3.8	30/50	16.2	35
Certificate of deposit	17.8	28	8.4	30/50	33.6	50
Equities	21.8	35	29.3	35/50	34.8	30
Mortgages	0.4	28	17.0	35/50	0.5	40
Others	5.9	—	3.8	—	3.4	—
Total	100.0	169	100.0	165/250	100.0	195

Source: Rofman, R. and Demarco, G. (1998)

lower-than-legal upper limits of their own, to avoid incurring the costs of asset liquidation when changes in the portfolio are required. Another reason for the lower-than-legal limits in Argentina is that the supervisor values the funds, and, in exceptional cases, this may result in differences between official prices and those assumed by the pension-fund managers.

Guarantees

Guarantees in the new pension systems are aimed mainly at safeguarding fund members against the risk of the fund's bankruptcy, and consequently against the risk of losing their benefit payments. On the other hand, in the case of people not covered by the fund system (e.g. the poor and the homeless) or those who will be unable to make a sufficient contribution towards their pension (e.g. the unemployed), the public authorities are organising a system of other social security measures.

In Chile there are four types of guarantee:

– Those who are not entitled to pension benefits (including the minimum pension) provided by the mandatory system receive a social allowance in the amount of 12% of the average wage.

– Those who have a record of no less than 20 years of service are paid the amount lacking to the minimum pension if the money accumulated on the individual account is lacking.

– An average investment return is guaranteed.

– Pension benefits are guaranteed if the insurance company goes bankrupt. The guarantees cover 100% of the minimum pension and 75% of the sum above the minimum wage up to a certain ceiling. All guarantees are paid from one budget, except for the average investment return, which is secured by pension funds themselves.

If investment return is at least 2% higher than wage growth, no guarantees are necessary. Problems evolve when low-paid workers quit to join the informal sector after paying contributions for 20 years. But ink such cases only the difference between the minimum pension and the accumulated money is covered.

Another problem is that 12% of the average wage (i.e. the social assistance mentioned above) is below the subsistence level, while 25% of the average wage is below the poverty line. This problem may be solved by offering a higher minimum pension for those who have contributed for a longer period of time, e.g. by paying a fixed amount for all plus 0.5% for each year contributions were paid.

All Latin American countries with private pension systems apply a related minimum investment return guarantee. Each fund must generate a minimum return over a certain period (usually 12 months) defined as a proportion of the average return obtained by the pension fund industry. The management companies (pension societies) are responsible for compensating fund members if the return is insufficient (in Argentina and Chile). If the guaranteed return is applicable to one year, the investment policy becomes short term-oriented. At present they are considering an extension to 3 or 5 years.

When the average investment return is guaranteed, all pension funds are compelled to behave in the same way. In addition, one year is too short a period for calculating returns, as under such conditions volatile funds are penalised, even though they produce better results over a longer term, whereas investments which are close to the permitted level are always profitable but bring lower returns than the average.

5.1.2. Supervision of Pension Funds in Latin American Countries

Generally, supervision institutions in Latin America are devoted entirely to pension funds. This is attributed to the fact that Latin American pension funds were created after or, in some cases, at the same time as the supervision agencies.

Comparing supervisory institutions of Latin American pension funds, one can observe significant differences in financing and the degree of autonomy enjoyed by the agency. In three countries the supervision agency has a significant degree of autonomy – both in administrative and political status. These three agencies are financed directly

Table 5.4. Institutional characteristics of pension-fund supervisory agencies in Latin America

Country	Area of government	Administrative and Political Independence	Funding source
Argentina	Ministry of labour and social security	Autonomous	Supervision fee
Bolivia	Treasury	Dependent	Supervision fee
Chile	Ministry of labour and social security	Dependent	National budget
Colombia	Central Bank	Dependent	Supervision fee
Mexico	Treasury secretary	Autonomous	Supervision fee (partial)
Peru	Ministry of the economy	Autonomous	Supervision fee
Uruguay	Central Bank	Dependent	National budget

Source: Rofman, R. and Demarco, G. (1998)

by supervised pension companies, through the payment of a fee. At the other extreme, the agencies in Colombia and Uruguay are a department of the Central Bank. Chile is a halfway house, since the supervisory agency is separate but with (administrative, political and financial) dependence on the ministry of labour and social security (cf. Table 5.4).

However, not only pension supervisory institutions oversee this industry. As it belongs to the larger financial sector of the economy, it is supervised by other institutions as well. For example, in Chile there are four institutions which have say in the industry: the *Superintendencia de Administradores de Fondos de Pensiones*; the *Superintendencia de Valores y Seguros* or Superintendent of Securities and Insurance; Central Bank of Chile; and the Risk Rating and Classification Commission.

In Uruguay all financial institutions are supervised by the Central Bank. In Argentina the *Superintendencia de Administradores de Fondos de Jubilacion y Pensiones* is joined by the Superintendent of Insurance, the Superintendent of Banking and the Superintendent of Securities at equal levels, along with the Central Bank, the Inland Revenue Bureau and the Department of Social Security.

Performance of supervision institution

Table 5.5 presents several features of currently operating supervisory bodies from the point of view of their effectiveness.

The Mexican supervisory institution is the largest of the seven agencies, at least in terms of the number of employees. But this reflects differences in the number of affiliates to pension funds (see Table 5.1) – over 14 million employees are covered in Mexico, compared with more than 7 million in Argentina, 6 million in Chile, 3 million in Colombia, just over 2 million in Peru and fewer than half a million in Bolivia. Consequently, Mexico's employee-to-fund-member ratio is the second lowest after Colombia. The very high ratios in Bolivia and Uruguay probably result from the relative youth of their systems and the small number of pension-fund members, which may cause problems due to a lack of scale, whereas the high ratio in Peru may indicate inefficiency.

The ratio of the budget to the revenues flowing into funds is less distorted. This measure shows how much of workers' contributions go to finance supervision (in systems where fees pay for supervision). Because the supervision agencies in Colombia and Uruguay are part of the Central Bank, it is unfortunately not possible to isolate their budgets from that of the parent institution. On this measure, the

Table 5.5. Latin America: Performance of Supervisory Institutions in Selected Countries

Country	Employees	Budget	Employees/ fund members	Employees/funds	Budget/ funds' assets	Budget/ funds' revenue
	number	$ million	per million	number	%	%
Argentina	183	12.5	30.5	10.2	0.14	0.36
Bolivia	21	1.9	63.9	10.5	1.80	1.80
Chile	134	7.0	23.2	10.1	0.02	0.28
Colombia	30	—	11.9	3.3	—	—
Mexico	214	26.3	19.1	12.6	0.42	0.95
Peru	85	5.1	73.9	14.2	0.34	1.23
Uruguay	21	—	45.7	4.2	—	—

Source: Rofman, R. and Demarco, G. (1998)

Note: Bolivia: budget/funds and budget/revenue are equal because the figures cover only one year of operation. The figures exclude the Bonosol/Bolivida programme cheapest agencies are those in Chile and Argentina, which spend between 0.25% and 0.50% of total revenues. The ratio of employees to the number of operating pension funds appears to be the most consistent indicator. Its value is close to 10 in most cases. The exceptions of Colombia and Uruguay reflect the fact that supervision is a part of the Central Bank, and so support services are part of the larger organisation and outside the supervision agency.

5.2. Experiences of Selected OECD Countries*

Pension funds in the OECD countries were established much earlier than pension funds in the Latin American countries. They developed along very different tracks and no tendency to unify them is visible today. However, one can identify a group of countries where pension funds are widespread or much more popular than elsewhere. These are where occupational pension schemes have been made mandatory. This is the case in Switzerland, Denmark, the Netherlands and Australia. One must also mention Sweden, which in 1998 significantly reformed the public pension system and introduced an obligatory capital segment into it, to which a mandatory premium of 2.5% is paid.

In the other countries, participation in capital pension funds is not obligatory, but they are so popular that they are a significant element of securing income for old age. These countries include the United States and the United Kingdom. Pension funds are also relatively popular in Belgium.

5.2.1. Activities of Pension Funds in Selected OECD Countries: the Comparative Perspective

As we have said, pension funds can have one of several legal formulas.

The legal structure of the private pension provision may be:

– Bank or insurance company,
– Management company, or
– Foundation/ trust/ mutual fund.

Pension fund assets may be wholly segregated, or mingled with other investors or asset managers.

Most countries require entire segregation of the assets belonging to pension funds either from the sponsor (employer) or management company. The pension fund can be set as a trust (Anglo-American countries), a foundation/mutual fund (European Countries) or a management company (Latin American countries). A book reserve system and accounts in financial institutions allows conjunction of assets.

Table 5.6. Pension fund assets and benefits paid in selected countries

Country	Fund assets as % of GDP	Share of pensions from PF as % of all retirement benefits	Working population covered
Belgium	4.0	8.0	31%
Denmark	60.1	18.0	80% [1]
The Netherlands	88.5	32.0	90%
Switzerland	70.0	n.a.	100%
Sweden	74.0	n.a.	90%
United Kingdom	79.4	28.0	50%
Australia	39.0	n.a.	n.a.
United States	66.0	n.a.	46%

Source: European Commission (1997) and OECD (1998 a, b). For working population: Laboul (1999), p. 30
Note: [1] - Regarding to employees only

Table 5.7 shows the diverse range of valuation methods used in OECD countries.

In Hungary, book value for assets valuation is used. Unrealised capital gains are not included. Assets value is recalculated quarterly at market prices. In Switzerland there is no insistence on valuing assets at market prices, therefore it is possible to manipulate prices. Artificial sales and purchases of shares occur in order to realise capital gains. Manipulation of returns in order to meet the established minimum is also possible in this way.

Most of the countries have adopted formal accounting standards – FAS 87 in the US, SSAP 24 in the UK, BiRiLiG in Germany – which are also used in pension fund accounting.

The problem of funding arises only for defined benefit (DB) pension plans. They may be fully or partly funded. Some countries impose minimum funding requirements in

* Chapter 5.2 is partly based on materials provided by Audrone Morkuniene, from the Lithuanian Free Market Institute.

Table 5.7. Valuation bases in OECD countries

Country	Equities		Bonds		Loans	Property
	Quoted	Unquoted	High quality	Low quality		
Belgium	market	market	repayment	mkt/purchase	outstanding	market
Denmark	mkt/purchase	mkt/purchase	amortised	amortised	amortised	mkt/purchase
Ireland	market	market	market	market	market	market
Netherlands	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	market
Sweden	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase	mkt/purchase
Switzerland	adjusted market	adjusted market	amortised	amortised	market	—
United Kingdom	market	adjusted market	market	market	market	Market
Australia	market	market	market	market	market	market
United States	market	market	amortised	mkt/purchase	mkt/purchase	mkt/purchase

Source: Rofman, R. and Demarco, G. (1998)

Note: 'mkt/purchase' means the lower of either the market or purchase price for quoted investments and the lower of the purchase price or written-down book value for unquoted. Belgium: repayment value used for securities issued or guaranteed by the public sector; the lower of the market or the purchase value applies to other high-quality bonds. Finland: mortgages are amortised, while other loans are adjusted to market value. Netherlands: bonds and loans can also be valued on an amortised basis. United States: data apply to New Jersey and Delaware

order to enhance the security of pension promises. Defined contribution (DC) schemes are fully funded by their nature.

In tax privileged DB schemes the problem of overfunding – and not only insufficient funding – may arise. Governments are usually concerned not to allow too high tax subsidies.

Many OECD countries – Australia, Belgium, Germany, Italy, Japan, Sweden and Switzerland – also set portfolio limits. In other countries, such as Canada, Denmark, Ireland, the Netherlands, the United Kingdom and the United States, there are no quantitative restrictions. However, pension funds are obliged to invest as a 'prudent person' would with his or her own money.

Most of countries have some type of limits on possible pension fund investments.

The actual structure of investments is shown in Table 5.8. It shows there is a significantly varied approach. Beside countries with a large degree of boldness in investing in

Table 5.8. Portfolio distribution of pension funds in selected OECD countries

Country	Equities	Private bonds	Public bonds	Loans	Other	Investments abroad
Australia (1)	27.0	20.0		n.a.	39.0	n.a.
Denmark	7.0	56.0	11.0	7.0	19.0	-
Ireland (2)	57.0	n.a.	n.a.	n.a.	7.0	n.a.
Netherlands	30.0	4.0	19.0	43.0	6.0	15.0
Sweden (1)	1.0	84.0		n.a.	14.0	n.a.
Switzerland	16.0	29.0		22.0	33.0	-
United Kingdom	63.0	3.0	11.0	-	23.0	18.0
USA	46.0	16.0	20.0	2.0	16.0	4.0

Source: World Bank (1994) p. 374, Davis (1993)

Notes: (1) For Australia and Sweden Bodie, Michell and Turner (1996). (2) For Ireland: OECD (1998 a, b)

Table 5.9. Simulated rate of return to private pension funds in selected countries: 1970 – 1990

Country	1970 – 75	1975 – 80	1980 - 85	1985 - 90	1970-1990
Denmark	-2.0	0.8	16.9	-	4.1
Netherlands	-1.5	1.9	10.4	6.2	4.2
Switzerland	-1.4	3.7	2.7	-0.2	1.2
United Kingdom	-0.5	5.0	12.4	8.0	6.1
USA	-1.6	-2.0	7.7	9.6	3.3

Source: World Bank (1994), Davis (1993)

more risky instruments (United Kingdom, Ireland), there are many examples of a moderate or even clearly conservative policy.

As regards the profitability, the rate of return of pension funds varied substantially not only between countries, but also in time spans (cf. data in the Table 5.9). The latter demonstrates how much pension funds depended on financial markets. On the other hand, the size of pension funds affected the structure of financial markets. Countries with large funded schemes tend to have developed securities markets, while in countries with small pension fund sector capital markets are relatively less developed [Blommestein, 1998].

Data covering the period 1967–90 seem to support the argument on differences in annual rates of return on pension fund investments between countries with prudent-person rules compared with those with quantitative limits. The first group gained relatively higher returns; more recently, the difference in returns between the two groups widened from 2.6 percentage points in 1984–93, to 4.3 in 1984–96 [Blommestein, 1998].

Despite the fact that most OECD countries have DC schemes, under which all risks are taken on by the employee, they do not impose a guaranteed investment return requirement. There are "guaranteed investment contracts" at insurance companies and "guaranteed deposit contracts" at commercial banks, promising interest lower by half than one-year government securities.

Contribution holidays are permitted in the event of surplus. Statutory surpluses may be refunded subject to a number of conditions, including indexation of present and future pensions.

Table 5.10. Vested rights in selected countries

Country	Entitlement of vesting rights	Transfer modalities
Belgium	Immediate on employee contribution 1 year on employer contribution	Transferability of vested reserves
Denmark	Immediate	Possibility of transfer of surrender value between occupational pension schemes
Netherlands	1 year	Possibility of transfer, under same conditions, within large network of pensions
Sweden (ATP)	Immediate	Full transferability of national plans
Switzerland	Immediate for minimum contribution	-
United Kingdom	2 years	Transfer to the pension funds
United States	5 years	Possibility of lump sum in case of transfer

Source: Laboul (1999), p. 33

Table 5.11. Indexation in private schemes in selected OECD countries

Country	Existence/ Legal status
Belgium	No indexation but possible adjustments
Denmark	No mandatory indexation, but usual in practice by allotment of bonus
Ireland	Indexation usual in practice
Netherlands	No mandatory indexation, but usual in practice
Sweden	Indexation
Switzerland	Optional indexation
United Kingdom	Benefits indexation
United States	Discretionary indexation

Source: Davis (1995), Laboul (1999)

Vested rights and portability differs significantly across countries, posing serious obstacles to the portability of pension rights between distinct pension schemes and countries. In certain countries the requirements are very strict. The vesting period is one year of service in Belgium; in Denmark – 5 years or age 30, whichever is the earlier; in Spain – immediate; in Ireland, 5 years; the Netherlands – 1; the UK – 2 years; Switzerland – immediate vesting of minimum benefits; Germany – age 35 or 10 years of service; and Luxembourg – from 5 up to 10 years.

Payments from pension funds may be in the form of annuities, periodical withdrawals or a lump sum. Some countries allow only annuities. Lump sum payments are usually restricted.

The indexation of private pensions is very rare. It can be applied both to pension benefits in payment and deferred pension rights. The examples of mechanisms applied in this regard in selected OECD countries are presented it the Table 5.11.

5.2.2. Brief Description of Pension Funds' Activities in Selected Countries

Denmark

An obligatory capital segment of securing income for old age (ATP) was introduced in Denmark in 1964. It provides benefits much higher than those from the public segment. Benefits from the first pillar account for a dozen or so percent of total retirement income, while the second pillar accounts for close to 70%. Approximately 90% of working people belong to ATP. Pension funds in the ATP system are managed by bodies representing employees and employers. When pension plans are defined contribution, employee representatives are in the majority.

Companies are required to calculate the current value of the vested benefits and to transfer that sum to the new plan. However, the way this sum is calculated is often left to the discretion of the managers, who tend to favour those who stay in the plan. The sum depends on the premises used in the calculation.

Netherlands

In the Netherlands, pension plans are mandatory through industry-wide agreements. Separate plans may be provided only by companies (usually large ones) that offer conditions not worse than industry plans. Insurance conditions are the same for all members. There are no choices, and therefore administrative costs are very low, about four times lower than those of insurance companies. Boards of management of pension plans consist of equal numbers of employees' and employers' representatives. There are no special rules or responsibilities imposed on the managers of pension arrangements other than in respect of financial safeguards and disclosure practices. Pension scheme assets must be fully segregated from the sponsor's assets.

Approximately 90% of all employed people belong to pension funds. The per capita asset value of these funds is the highest in the world. The investment policy used to be conservative. A significant move towards shares was only effected 10 years ago.

Funding is obligatory not only during the investment period, but also in the phase of annuity. Contribution holidays are permitted in the event of surpluses but not reversions.

Entitlements of vesting rights are applied after one year. Accrued benefits are indexed. There is transferability within pension circuits with the same conditions.

So as to prevent the imposition of age requirements, the law regulates participation conditions: all employees over the age of 21 or with one year of service are to be included in a pension plan if it is applicable for that particular professional group.

The Netherlands put a ceiling on pension benefits provided from tax-privileged plans so that they do not divest all earnings. They therefore establish not only vesting periods, but also benefit-accrual schedules so as to prevent the acquisition of either very extensive or very limited rights to pensions during a minimum obligatory period.

The Netherlands pension fund members must be offered annuities as they reach the retirement age.

Switzerland

In Switzerland since 1985 all employers must provide old–age, survivor's and disability pensions for their employees. DC schemes are mandatory for all employees in a company. Employees have no choice other than to accept labour and pension contracts together. Workers contribute up to 50% of total contributions. Death and disability risks must be insured.

Yet certain groups, such as young employees, employees of retirement age or low-income workers, may be excluded from mandatory schemes. Pension schemes are not obligatory for employees under 25. In Switzerland, people earning less than 40% of the average wage are not required to pay into second-pillar pension funds.

In Switzerland pension funds are established as foundations with full legal separation of the pension fund from the employer–sponsor. Pension fund councils (management) must comprise equal numbers of employers' and employees' representatives.

Maximum investment limits for Swiss pension funds are:
- 100% cash and fixed interest,
- 80% property,
- 50% equities and other securities,
- 30% foreign bonds with a maximum of 5% per debtor,
- 30% foreign currency bonds, equities, securities.

In reality Swiss pension fund investments concentrate 62% in fixed income securities and 38% in equities and real estate. Switzerland is subject to the severest investment restrictions:

– in Switzerland the pension fund must guarantee a nominal 4% investment return annually,

– all plans need approval from an expert that they are properly financed,

– a mandatory minimum pension benefit is set.

Sweden

Since 1998, 2.5% of pensionable earnings have been set aside and transferred into a fully funded pension system.

This part is administered separately from the pay-as-you-go system. The rest of the administration and insurance function of this sub-system is under public responsibility. The scheme has the following characteristics:

– contributions are accumulated in one or several funds which the individual chooses,

– the amount in the funds increases by the investment yield on the savings that are deposited,

– the pension is determined by the conventional private insurance principle.

United Kingdom

In the UK a pension scheme must be established under irrevocable trust managed by trustees who are personally responsible for the investment of the assets in a prudent way. Small companies are generally managed by insurance companies.

The UK recently brought in a requirement under the Pensions Act 1995 giving members a right to nominate trustees.

There are mandatory minimum funding requirements. Funds may not be below actuarial obligations. In cases of more than 10% underfunding the employer is either required to provide securities or to transfer the shortfall to the fund. The 1995 Pensions Act introduced a minimum funding legislation, which requires DB plans to hold sufficient assets to meet their liabilities in the event of immediate wind-up.

In the UK written principles of investment decisions are mandatory.

The management of assets is governed by several broad concepts:

– Investment decisions must be made in a prudent and reasonable manner on the basis of a level of skill, expertise and diligence that would be expected of a person with similar investment responsibilities. This is called the prudence requirement and is the most basic concept that underlines the whole regulation.

– Investment decisions must be made for the exclusive purpose of providing benefits.

– Assets must be diversified so as to minimise the risk of large losses.

There is a compensation scheme for funded plans to provide up to 90 per cent of liabilities in the event of an offence involving dishonesty. Solvency margins are regulated.

Vesting applies after 2 years, as does indexation of accrued benefits. Members have the right to transfer to other pension funds, but there is no obligation on a fund to accept a transfer from another fund.

The maximum increase of the annual pension payment is whichever is the highest: 3% above an increase in the retail price index, or as required by social security. Limited price indexation (retail price increases up to 5%) must apply to all benefits earned from April 1997, with the exception of Additional Voluntary Contributions.

A maximum lump sum payment permitted at normal pension age is 1.5 times the final remuneration after 20 years of service (less for shorter periods of service).

United States

In the USA, private pensions are employer sponsored schemes operating on a purely voluntary basis. Supplementary pensions can be both private and public (from the government as an employer).

The sponsor plays a key role in the system by collecting contributions, holding assets for investment and paying out benefits. The number of private plans has increased from about 300,000 in 1975 to about 700,000 today. The majority are single employer plans. Only 3,000 are sponsored by unions.

Pension plans cover about 50% of the full-time workforce. Of these, one third are in defined benefit, one third are in defined contribution, and one third are in both. Many DC plans (401) operate as supplements to DB plans, allowing employees to make their own contributions.

In the USA, the tax laws can be viewed as a means of establishing a basic structure for the financing and benefits of pension plans. They are very specific in terms of how benefits must be distributed among the workers in an enterprise and the amount of funds that must be set aside each year to pay for these benefits.

Among the most important of these rules are the following general requirements:

– workers have an irrevocable right to benefits after working a maximum of five years,

– at least 70% of workers participate in the plan in most cases,

– highly paid employers and owners of companies cannot receive benefits that are more than their salaries,

– the maximum level of benefits that may receive special tax treatment must be established, and

– the sponsor sets aside in a separate legal account sufficient funds to pay for the benefits promised.

Pension funds in the USA are established as trusts. Even 401 plans, which may be individual DC schemes, should have a trust established with its trustees, even if the whole management is delegated to investment funds. If a pension fund outsources all its activity, the responsibility remains with the trustees appointed by the pension fund founder.

In the USA, the Employee Retirement Income Security Act of 1974 (ERISA) created a system of legal requirements and enforcement to ensure that the assets set aside are adequately safeguarded. The protection of assets is ensured by the application of fiduciary requirements: the assets must be segregated from those of the sponsor of the plan. They have to be held in the custody of a third party (or trust) and managed solely at the discretion of the trustee.

The US tax laws specify minimum standards for the fairness and funding of pension plans that must be met to obtain special treatment. This is one of the major regulatory mechanisms for employee benefits.

ERISA provides a regulatory framework for the application of investment standards by:

– providing relatively specific definitions of what constitutes the assets of a pension trust,

– establishing a relatively broad functional of who is construed to be responsible for the management of these assets (the fiduciaries),

– imposing significant liabilities on these fiduciaries.

In practice this regime creates a very flexible set of standards. This may by interpreted as its strength because it is continually adaptable to the rapidly changing financial markets. It is also, however, a source of considerable difficulties in implementation due to the degree of uncertainty it may impose on practitioners and the interpretative burdens it places on the regulators.

Another principle of ERISA in governing US private pension funds is that it is essentially a conflict of interest statute. The law specifies parties or individuals that may have interests that are in opposition to those of the trust, and prohibits them from engaging in transactions with the trust.

Pension plans now hold more than one-fifth of the total financial assets in the US economy. About 40% of the assets are invested in pools managed by banks and insurance companies.

The US, like the Netherlands, put a ceiling on pension benefits derived from tax-privileged plans so that they do not divest all earnings. Indexation of benefits is not obligatory, but almost universal in practice. The Pension Benefit Guarantee Corporation was established in 1974 to guarantee pension benefits up to a specific ceiling. All private DB plans must participate.

Australia

Retirement benefit coverage has become mandatory for Australian employees – a policy embodied in the Superannuation Guarantee in 1992. The government legislated that employers should pay into an "approved" superannuation fund a percentage of the earnings of their employees, thus effectively making mandatory what had been, since the mid-eighties, part of a national agreement between employers and employee organisations.

A phase-in schedule was also legislated, with employer contributions rising to 9% of earnings by the year 2002. It is envisaged that, by then, a 3% employee contribution will also be required. As a result of this *mandatory retirement saving* policy, superannuation coverage has increased from 40% of all employees in 1987 to over 90% in 1995.

Australian superannuation funds face few investment restrictions. There are no asset requirements or floors and no minimum rate of return requirements. As a result, superannuation funds tend to invest in a wide variety of assets with a mix of duration and risk/return characteristics.

Until the 1980s, the Australian superannuation market was largely self-regulated and was therefore subject to much less control than was the practice elsewhere. However, in conjunction with its policy of broadening the coverage of superannuation the government began to play a larger role in the regulation and supervision of the industry.

The first major regulatory initiative was the implementation of in-house asset limits in March 1985. This was followed by the introduction of a comprehensive set of operational standards for superannuation funds under the **Occupational Standards and Supervision Act (OSSA) and Regulations of 1987**. This legislation established an industry supervisory body, the **Insurance and Superannuation Commission (ISC)**, and set out requirements for tax concessions, investments, benefit standards, member participation and reporting and disclosure. As the Australian Government does not have the constitutional power to make laws concerning superannuation per se, the enforcement of OSSA was tied to the tax concessions provided to superannuation funds. Superannuation funds that did not comply with the requirements of OSSA were not eligible for superannuation tax concessions. The main tax concession for compliant funds is the 15% rate on fund income. Non-compliant funds are subject to tax at the top personal marginal rate.

In 1993 OSSA was superseded by the **Superannuation Industry Supervision (SIS)** legislation, which increased the level of prudential supervision and required standards of the industry. The SIS expanded the jurisdiction of the regulatory body, the ISC, providing it with greater enforcement powers. It also clarified the duties and responsibilities of trustees and investment managers, and encouraged greater member participation. Previously the ISC shared the responsibility with other regulators, including the Reserve Bank, The Australian Securities Commission and the State Government.

One of the main innovations of the SIS has been to place the regulation of superannuation funds on a different legal basis under the constitution. Previously, the Australian Government's taxation power was used, and eligibility tax concessions were dependent upon a fund complying with OSSA. A particular problem with this approach, however, was that the only sanction for non-compliance was the withdrawal of a fund's tax concessions, which would hurt fund members rather than the trustees who were responsible for the breach of regulations.

To overcome this problem, the SIS is enacted under the Australian Government's corporations and pension powers, in addition to the taxation power. This strengthens the ability of the Australian Government to legislate in the area of superannuation and, in particular, allows legislation to target individuals responsible for intentional or reckless non-compliance with the duties and standards contained in the SIS legislation.

The current regulatory framework covers three main areas: industry supervision, contributions and benefit standards, and member rights.

– *Industry standards*

SIS makes trustees solely responsible for the prudent operation of their funds. To enhance this, the SIS codifies the duties of trustees and investment managers. This approach allows them maximum commercial autonomy in their investment decisions.

Trustees are personally liable under both civil and criminal law for breaches of their obligations. Penalties range from disqualification and fines to prison terms. The regulatory framework also extends to other service such as investment managers, custodians, auditors and actuaries.

– *Investment Standards*

In light of the obligations of trustees to formulate and implement an investment strategy, the SIS imposes a number of restrictions on the investment of superanuation fund assets. These include:

– Investment in in-house assets must not exceed a statutory maximum. A reduction in the statutory maximum from 10% of the cost to 5% of the market value of assets is being phased in by 2000/2001.

– Borrowing except on a short-term basis to make benefit payments or to cover settlement of securities transactions is prohibited.

– Funds must be maintained for the "sole purpose" of providing retirement benefits, so they cannot be used as a means of conducting business.

– All investment must be on an arm's length basis.

– Loans or financial assistance to, or acquisitions from, members (or their relatives) are prohibited.

Importantly, however, the investment restrictions extend neither to asset requirements or limitations nor a required rate of return. Neither is there a government guarantee of member benefits. Instead, the security and adequacy of superannuation benefits relies upon compliance with the supervisory regime established under the SIS. Particularly important is the requirement that an investment policy be formulated and that it be implemented according to the prudent person principle.

– *Reporting requirements*

The SIS legislation was introduced essentially to protect the interests of members. One way of enhancing this is to keep members fully informed. As such, the reporting requirements have been designed to facilitate members' understanding of their superannuation entitlements and the investment policy and performance of the superannuation fund. The SIS requires that trustees report regularly to fund members and, when requested, disclose certain information. This includes both member specific and fund details.

Member specific reports are to be sent to members on at least an annual basis, when they join or leave a fund, and in case of "one-off" special events. They are to include details of contributions, accrued benefits, earnings, fees and charges deducted, and other benefits such as for death or disability. Fund information is generally sent to members in the form of an annual report. This must include details of the trustees and fund managers, the main accounting and financial data and the main investment information. Investment information must include the investment strategy of the fund; details of investments that exceed 5% of assets; the earnings of the fund; and the reserving policy. Members can obtain other relevant information on request.

– *Contribution and benefit standards*

Contribution and benefit standards aim to ensure the superannuation funds are used for genuine retirement income needs and not for other purposes such as the short-term exploitation of tax concessions.

The SIS attempts to address this by establishing rules relating to the contributions made to, and benefits received from, the superannuation funds. These include rules relating to the age limits for acceptance of contributions and payments of benefits, the employment status of fund contributors, access to benefits by members (the preservation of *minimum payment standards*) and the minimum benefits owned by members (vesting or *minimum benefit standards*).

– *Contributions*

A fund may accept contributions or, in the case of a defined benefit scheme, grant benefit accruals in limited circumstances only. The general rule is that contributions can be accepted only until a member is aged 65, and only if the member is or was within the past two years in the paid workforce or is no longer in the workforce because of ill health.

– *Benefits*

Prior to the introduction of mandatory employer contributions, vesting, preservation and portability generally only applied to employee contributions and the earnings thereon. Under OSSA some compulsory vesting, preservation and portability was introduced and this has been extended under the SIS legislation.

The SIS contains minimum benefits standards ensuring full vesting applies to all member and mandatory employer contributions provided under awards or the Superannuation Guarantee, and the investment earnings on these contributions. Vesting is not required for non-mandatory employer contributions.

In Australia vested rights are deferred until retirement age; they are not transferred to another fund. As a consequence, each worker can hold several accounts with only one active (contributions paid in).

The minimum payment standards in the SIS require that superannuation benefits be fully preserved to the statutory preservation age. Since July 1, 1996, this has applied to all superannuation benefits that have been subject to concessional taxation. Generally, it is required that benefits be preserved until the statutory preservation age. This is currently 55, but is being progressively increased to 60 by the year 2025. Earlier withdrawals are available in the event of death, temporary or permanent disability, permanent departure from Australia and, with the discretion of the ISC, the cases of financial hardship.

Preserved benefits are also portable between funds. When a member leaves an employer, preserved benefits can be transferred to a new employer's superannuation fund, to a master trust, an approved deposit fund or an eligible rollover fund. Alternatively, they can be used to buy a *deferred annuity* from a life insurance company.

– Members' rights

The SIS provides for considerable member participation in the operation and management of superannuation funds. At least 50% or half of the trustees of superannuation fund should be members. Members of all funds are required to receive certain fund and member information on a regular basis; and members have the right to bring civil and criminal action against trustees and investment managers who have failed in their duties. In addition, members have access to a comprehensive mechanism for resolving disputes through compulsory, fund-based, internal arrangements and if these fail under the *Superannuation Complaints Tribunal*.

5.2.3. Supervision Over Pension Funds

Status of the supervisory authority

Table 5.12 shows the situation in OECD countries. Pension-fund supervision is usually the responsibility of a separate agency, although ministries are directly involved in Austria, Finland, Greece, Japan, Spain and the USA (first column). In 17 countries the supervision of pension funds is part of the supervision of other insurance markets (second column). Pensions and insurance have a number of common characteristics, such as similar organisation and operation. Insurance companies have a major role in the pension sector in many countries, managing 20–30 per cent of total pension assets across the OECD. They often offer group-insurance plans and act as investment and benefit managers.

The agency responsible for pension-fund supervision also sets regulations in selected countries (third column).

The Australian Prudent Regulation Authority oversees in Australia both the Bank Supervision Department of the Reserve Bank of Australia and the Insurance and Superannuation Commission, which in turn oversees superannuation funds, life and general insurance and insurance brokers.

In the Netherlands pension funds are supervised by the Dutch Insurance Chamber, along with life insurance companies. Solvency is top priority. The framework of rules is quite liberal. In Ireland there are the Pension Board and Irish

Table 5.12. Supervisory authorities in OECD countries

Country	Supervision	Insurance	Regulation
Australia	Insurance and Superannuation Commission	same	same
Belgium	Insurance Supervisory Office	same	Ministry of Economic Affairs/ same
Denmark	Financial Supervisory Authority	same	same
Ireland	Pension Board	Irish insurance federation	Ministry of Enterprise and Employment
Netherlands	Insurance Supervisory Body	same	Ministry of Social affairs and Employment
Sweden	Financial Supervisory Authority	same	same
Switzerland	Federal Office of Social Insurance/Federal Office of supervision of private insurance	same	Federal ministries
United Kingdom	Financial services authority and occupational pensions regulatory authority	same (financial services authority)	Departments of Trade and Industry and Social Security
United States	Department of Labor (Pension and welfare benefits administration)	Department of Commerce and the National Association of Insurance Commissioners	same

Source: Rofman and Demarco (1998), Laboul (1999)

Revenue Commissioners. In Germany book reserve arrangement and support funds are supervised by the Ministry of Finance. Pension funds and insurance contracts are supervised by the insurance supervision authority, BAV.

In 1997 OPRA – the Occupational Pensions Regulatory Authority – was established in the UK. It can suspend a pension scheme or replace it by other schemes. The Inland Revenue Office also exercises control relating to fiscal matters. There is a Pensions Ombudsman institution and Occupational Pensions Advisory service.

In the US the regulation of pension plans is conducted exclusively by two agencies of the Federal Government: the Internal Revenue Service and the Department of Labour. Pension plans are provided with special tax status in which contributions to plans and earnings from investments are not generally taxed until they are distributed to employees. These tax provisions are extremely complex. They are administered by the Internal Revenue Service of the Treasury Department.

The legal basis for the regulation of pension funds in the US was established by the Employee Retirement Income Security Act of 1974, commonly known as ERISA. ERISA provides a uniform basic structure and requirement for private pension plans, and a system for providing government guarantees of the benefits for DB plans. Enforcement of ERISA is carried out by the Pension and Welfare Benefits Administration of the Department of Labour.

Powers of supervision

The US Department of Labour is provided with broad authority:

– to interpret and apply the general principles embodied in the statute,

– to obtain information and to investigate pension plans that appear to be in violation of standards,

– to refer cases to the Federal courts to recover any loses that may result from the failure of fiduciaries to adhere to ERISA requirements.

Each year the Department of Labour conducts about 2,500 investigations into pension plans. When indications of a violation of the law are found, an attempt is made to reach a voluntary agreement that will correct the violation.

Most of the cases are resolved in this manner, which usually involves the repayment of monies to the pension fund or the sale of assets that represent a conflict of interest. If an agreement can not be reached or there is evidence of criminal activity the case is referred to the appropriate legal authorities in the federal government and ultimately the courts.

The supervisory authority does not have authority to go to the courts on its own. In the United Kingdom the Occupational Pensions Regulatory Authority (OPRA) has wide powers to ensure that trustees, employers and their advisers comply with their statutory duties, and to impose penalties and disqualification when they do not. Plan auditors and actuaries have "whistle blowing" functions.

In Ireland the Pension Board has powers under the Pensions Act of 1990 to ensure that trustees and others involved with pension plans comply with their statutory duties. There are mandatory "whistle blowing" requirements for all involved with pension plans in relation to fraud or misappropriation and also voluntary "whistle blowing".

Information disclosure

Disclosure requirements, that is one of the main instruments in pension fund supervision, vary enormously in Europe. The United Kingdom and Ireland have the most comprehensive rules. Irish and UK trustees must provide a statement of individual benefits and an audited annual report nine months after the year-end in Ireland and one year after in the United Kingdom. Trust deeds must be made available as well. Members of employer-based schemes must be informed of eligibility rules, the calculation of contributions and the type and level of benefits. In the report trustees must account for the collection of contributions, the number of beneficiaries, asset investments and the payment of benefits. In addition they need to provide an actuarial valuation of assets and liabilities, performance rating and remuneration of managers.

In the US, pension fund members must receive an annual report outlining the plan and the rights to receive a pension. Austria, Denmark, France, Spain and Switzerland also have legal requirements to inform members. In other countries, such as Belgium, Germany, Italy, Luxembourg, the Netherlands, Norway and Sweden, there is no legal requirement to inform members, and there exists the risk that plan members do not have adequate information to assess the performance of their funds.

EU requirements

In 1997 The European Commission issued a Green paper, "Supplementary Pensions in the Single Market", the core elements of which were freedom of investments based on the prudent person principle, freedom to choose asset managers and custodians, and a level playing field between operators (life insurers vs. pension funds).

Assets held by funds of EU member states comprise 20% of the EU GDP. However, it is the only major financial sector without any explicit legal EU framework. Within the EU, there is:

– no transferability of private pension rights,

– no cross-border membership of pension funds,

– a number of investment restrictions.

Equal treatment of men and women is the fundamental EU requirement applicable to pension schemes. The retirement age and contributions may not vary for men and women within the EU countries after the Barber case of 1990 and the Coloroll case of 1994. However, this requirement will be enforced fully only for schemes started after May 17, 1990 so that the existing schemes would not be injured financially. Spouses' pensions have to be equal as well. No distinction of part-time workers is permitted. The retirement age may be increased for any gender so that it is the same for both [Avdel Systems Ltd case, 1994].

After the Barber case the European Court acknowledged that pensions represent deferred wages i.e. salaries, but not remuneration for loyalty. Close attention should therefore be paid as to how employers meet their liabilities and whether pension rights are lost upon job changes.

While the EU treaty sets the goal of free movement of capital within the member countries, many restrictions to invest outside the countries still exist [7].

Conclusion

It is difficult to compare Latin American supervision institutions with those in OECD countries because their design is quite different. Latin American supervision is more proactive. For example, in the US, the Department of Labour reviews just 1% of pension-related documents each year. Supervision institutions in Latin America are devoted entirely to pension funds, which is not always the case in OECD countries. One of the main reasons for these different approaches is historical: in developed countries privately managed pension schemes had existed for some time before the supervisory agency was created. Therefore, the supervision structure had to be adapted to the shape of the pensions industry. In contrast, Latin American pension funds were created after or, in some cases, at the same time as supervision agencies. Although Austria, Ireland, Italy, the Netherlands, the United Kingdom and the USA have comprehensive pension laws as in Latin America, in other OECD countries regulations are found across a range of legal provisions.

[7] For example in the Article 73b.1. of the Treaty: "Within the framework of the provision set out in this chapter, all restrictions on the movement of capital between (EU) Member States and between Member States and third countries shall be prohibited."